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2019

# A Series of Case Studies: An Analysis of Key Accounting Issues

Jordan Haley Enlow  
*University of Mississippi*

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A SERIES OF CASE STUDIES: AN ANALYSIS OF KEY ACCOUNTING ISSUES

by

Jordan Haley Enlow

A thesis submitted to the faculty of The University of Mississippi in partial fulfillment of  
the requirements of the Sally McDonnell Barksdale Honors College.

Oxford

May 2019

Approved by

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Advisor: Dr. Victoria Dickinson

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Reader: Dean W. Mark Wilder

## ABSTRACT

### JORDAN HALEY ENLOW: A Series of Case Studies: An Analysis of Key Accounting Issues

(Under the Direction of Victoria Dickinson)

This thesis was written on a series of case studies completed while taking ACCY 420 under the direction of Dr. Victoria Dickinson. This class, taken in the fall and spring of 2017-2018, was taken in conjunction with Intermediate Financial Accounting. Taking ACCY 420 along with Intermediate Financial Accounting added an application aspect to learning financial concepts. ACCY 420 did this by covering various areas of financial reporting in great detail through delving into numerous companies, both U. S. based and international, and analyzing their financials.

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The University of Mississippi

ACCY 420

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Home Heaters, Inc.

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Jordan Haley Enlow

September 5, 2017

## Introduction:

This case study concerns two companies, Glenwood Heating, Inc. and Eads Heaters, Inc. This case highlights the fact that the accounting principles used in managing a company are of utmost importance. The way this case does this is by presenting two extremely similar companies – they had the same Sales, Dividends, Starting cash, Land, Buildings, Equipment, collected the same amount from their accounts receivable, paid the same amount toward their account, interest, and note payables – and making small divergent management decisions and showing the changes caused by the differing methods. For example, the companies accounted for cost of goods sold differently, Glenwood used FIFO while Eads chose to use LIFO. Also, Eads estimated a higher bad debts expense, which lowered their net income.

I learned the way that a business accounts for cost of goods sold can be the difference between having a higher net income and thus being more attractive to potential investors or lenders, and having a low net income and being much less attractive to potential investors. What I feel I could use from this case in my future job is the knowledge that finding the right mix of GAAP principles for your company is extremely important. Throughout this case I also developed a much more thorough understanding of the general accounting process and how all the individual parts fit together. I felt this case study drove home the idea of it being immensely more helpful to one's learning process to place yourself in a real-world context instead of only thinking about textbook definitions and exercises.

## Executive Summary:

*Which company would you rather invest in or lend money to, and why?*

The safest company to invest in or to lend money to is Glenwood Heating, Inc.

Both companies have the same amount of sales, but Eads Heaters, Inc. has more total expenses than Glenwood. Eads also has a higher bad debt expense, meaning they do not collect as high of a percentage of their accounts receivable as does Glenwood. Glenwood has a lower cost of goods sold because of the difference in their methods of calculating cost of goods sold. Therefore, Glenwood has a higher net income than Eads, and likewise higher retained earnings. While Eads does have more cash on hand, plant, property, and equipment comprises a greater portion of their assets relative to Glenwood's, thus leaving Eads a less liquid company than Glenwood.

### ➤ Exhibit 1: Income Statements

It is shown (highlighted in green) that each company had the same sales amount.

The three items that add to total expenses for each are highlighted in red;  $\$70,194 + \$27,650 + \$30,914 = \$128,758$  for Glenwood and  $\$80,670 + \$35,010 + \$23,505 = \$139,185$  for Eads. In yellow, cost of goods sold is compared, and it clearly shows Glenwood with the lower cost of goods sold. Bad debt expense for Glenwood is \$994 while Eads bad debt expense is much higher, coming in at \$4,970. Highlighted in grey is net income for each: \$92,742 for Glenwood and \$70,515 for Eads.

<b>Glenwood Heating, Inc.</b>		
<b>Multistep Income Statement</b>		
<b>For Year Ended December 31, 20X1</b>		
Sales		\$ 398,500
Cost of goods sold	\$ (177,000)	
<b>Gross profit</b>		\$ 221,500
<b>Operating Expenses</b>		
Selling and Administrative expenses		
Depreciation expense – building	10,000	
Depreciation expense – equipment	9,000	
Bad debts expense	994	
Rent expense	16,000	
Other operating expenses	34,200	
Total operating expenses	\$ 70,194	
		(70,194)
Income from operations		\$ 151,306
<b>Other revenues and expenses</b>		
Interest expense	(27,650)	
Total other revenues and expenses		(27,650)
Income before tax		\$ 123,656
Less: Income tax expense		(30,914)
<b>Net Income</b>		<u>\$ 92,742</u>



<b>Eads Heaters, Inc.</b>		
<b>Multistep Income Statement</b>		
<b>For Year Ended December 31, 20X1</b>		
Sales		\$ 398,500
Cost of goods sold	\$ (188,800)	
<b>Gross profit</b>		\$ 209,700
<b>Operating Expenses</b>		
Selling and Administrative expenses		
Depreciation expense - building	10,000	
Depreciation expense - equipment	20,000	
Depreciation expense - leased equipment	11,500	
Bad debts expense	4,970	
Other operating expenses	34,200	
Total operating expenses	\$ 80,670	
		\$ (80,670)
Income from operations		\$ 129,030
<b>Other revenues and expenses</b>		
Interest expense	35,010	
Total other revenues and expenses		(-35,010)
Income before tax		\$ 94,020
Less: Income Tax		(23,505)
<b>Net Income</b>		<u>\$ 70,515</u>

➤ Exhibit 2: Statements of Retained Earnings

Because each company paid out the same dividends and Glenwood had a larger net income, Glenwood's year end retained earnings are also higher than Eads's.

<b>Glenwood Heating, Inc.</b>	
<b>Statement of Retained Earnings</b>	
<b>For Year Ended December 31, 20X2</b>	
Retained earnings, Dec 31, 20X1	\$ -
Plus: Net Income	92,742
Less: Dividends	(23,200)
Retained earnings, Dec 31, 20X2	<u>\$ 69,542</u>

<b>Eads Heaters, Inc.</b>	
<b>Statement of Retained Earnings</b>	
<b>For Year Ended December 31, 20X2</b>	
Retained earnings, Dec 31, 20X1	\$ -
Plus: Net Income	70,515
Less: Dividends	(23,200)
Retained earnings, Dec 31, 20X2	<u>\$ 47,315</u>

➤ Exhibit 3: Classified Balance Sheets

While Eads does indeed have more cash on hand than Glenwood does (highlighted in green), Eads also has a good deal more of its assets tied up in its Property, Plant, and Equipment. PPE are highlighted in yellow for each company.

<b>Glenwood Heating, Inc.</b>			
<b>Classified Balance Sheet</b>			
<b>Assets</b>		<b>Liabilities</b>	
Current assets		Current liabilities	
Cash	426	Accounts payable	26,440
Accounts Receivable	99,400	Interest payable	6,650
Inventory	62,800	Current portion of notes payable	20,000
Less: Bad debts expense	(994)	Long-term liabilities	
		Notes payable	360,000
Property, plant, and equipment		Total liabilities	\$ 413,090
Land	70,000	<b>Equity</b>	
Building	350,000	Common stock	160,000
Equipment	80,000	Retained earnings	69,542
Less: Accumulated depreciation	(19,000)	Total equity	\$ 229,542
Total assets	<u>\$ 642,632</u>	Total liabilities and equity	<u>\$ 642,632</u>

<b>Eads Heaters, Inc.</b>			
<b>Classified Balance Sheet</b>			
<b>Assets</b>		<b>Liabilities</b>	
Current assets		Current liabilities	
Cash	7,835	Accounts payable	26,440
Accounts Receivable	99,400	Interest payable	6,650
Inventory	51,000	Current portion of lease payable	9,330
Less: Bad debts expense	(4,970)	Current portion of notes payable	20,000
		Long-term liabilities	
		Notes payable	360,000
Property, plant, and equipment		Lease payable	74,030
Land	70,000	Total liabilities	496,450
Building	350,000	<b>Equity</b>	
Equipment	80,000	Common stock	160,000
Leased equipment	92,000	Retained earnings	47,315
Less: Accumulated depreciation	(41,500)		
		Total equity	207,315
Total assets	<u>\$703,765</u>	Total liabilities and equity	<u>\$ 703,765</u>

## Appendix:

### ➤ Part A

#### Home Heaters - Glenwood Part A: Recording basic transactions

	Assets						=	Liabilities			+	Stockholder's Equity	
	Cash	Accounts recievable	Inventory	Land	Building	Equipment	Accounts payable	Note payable	Interest payable		Common stock	Retained earnings	
No. 1	160,000										160,000		
No. 2	400,000							400,000					
No. 3	(420,000)			70,000	350,000								
No. 4	(80,000)					80,000							
No. 5			239,800				239,800						
No. 6		398,500										398,500	
No. 7	299,100	(299,100)											
No. 8	(213,360)						(213,360)						
No. 9	(41,000)							(20,000)				(21,000)	
No. 10	(34,200)											(34,200)	
No. 11	(23,200)											(23,200)	
No. 12									6,650			(6,650)	
Balances	47,340	99,400	239,800	70,000	350,000	80,000	26,440	380,000	6,650		160,000	313,450	

#### Home Heaters - Glenwood Trial Balance - Part A

	<u>Debits</u>	<u>Credits</u>
Cash	47,340	
Accounts receivable	99,400	
Inventory	239,800	
Land	70,000	
Building	350,000	
Equipment	80,000	
Accounts payable		26,440
Note payable		380,000
Interest payable		6,650
Common stock		160,000
Dividend	23,200	
Sales		398,500
Other operating expenses	34,200	
Interest expense	27,650	
<b>Total</b>	<u>\$971,590</u>	<u>\$971,590</u>

**Home Heaters - Eads**  
**Part A: Recording basic transactions**

	<b>Assets</b>					=	<b>Liabilities</b>			+	<b>Stockholder's Equity</b>	
	Cash	Accounts receivable	Inventory	Land	Building	Equipment	Accounts payable	Note payable	Interest payable		Common stock	Retained earnings
No. 1	160,000										160,000	
No. 2	400,000							400,000				
No. 3	(420,000)			70,000	350,000							
No. 4	(80,000)					80,000						
No. 5			239,800				239,800					
No. 6		398,500										398,500
No. 7	299,100	(299,100)										
No. 8	(213,360)						(213,360)					
No. 9	(41,000)							(20,000)				(21,000)
No. 10	(34,200)											(34,200)
No. 11	(23,200)											(23,200)
No. 12									6,650			(6,650)
<b>Balances</b>	<u>47,340</u>	<u>99,400</u>	<u>239,800</u>	<u>70,000</u>	<u>350,000</u>	<u>80,000</u>	<u>26,440</u>	<u>380,000</u>	<u>6,650</u>		<u>160,000</u>	<u>313,450</u>

**Home Heaters - Eads**  
**Trial Balance - Part A**

	<u><b>Debits</b></u>	<u><b>Credits</b></u>
Cash	47,340	
Accounts receivable	99,400	
Inventory	239,800	
Land	70,000	
Building	350,000	
Equipment	80,000	
Accounts payable		26,440
Note payable		380,000
Interest payable		6,650
Common stock		160,000
Dividend	23,200	
Sales		398,500
Other operating expenses	34,200	
Interest expense	27,650	
<b>Total</b>	<u><b>\$971,590</b></u>	<u><b>\$971,590</b></u>

➤ Part B

Glenwood Heating Inc.

Part B: Recording Additional Information

Transaction	Assets						
	Cash	Accounts receivable	Allowance for bad debts	Inventory	Land	Building	Accumulated Depreciation Building
Balances: Part A	47,340	99,400	0	239,800	70,000	350,000	0
Part B (1) Bad debts			(994)				
Part B (2) COGS				(177,000)			
Part B (3) Depreciation Building							(10,000)
Part B (4) Equipment							(9,000)
Rental Payment	(16,000)						
Part B (5) Income Tax	(30,914)						
Balances	426	99,400	(994)	62,800	70,000	350,000	(10,000)
						80,000	(9,000)

	Accounts payable	Note payable	Interest payable	Common stock	Retained earnings
Balances: Part A	26,440	380,000	6,650	160,000	313,450
Part B (1) Bad debts					(994)
Part B (2) COGS					(177,000)
Part B (3) Depreciation Building					(10,000)
Part B (4) Equipment					(9,000)
Rental Payment					(16,000)
Part B (5) Income Tax					(30,914)
Balances	26,440	380,000	6,650	160,000	69,542

Eads Heaters, Inc.  
Part B: Recording Additional Information

Transaction	Assets									
	Cash	Accounts receivable	Allowance for bad debts	Inventory	Land	Building	Accumulated Depreciation Building	Equipment	Accumulated Depreciation Equipment	Leased Equipment
Balances: Part A	47,340	99,400	-	29,800	70,000	350,000	-	80,000	-	-
Part B (1) Bad debts			(4,970)							
Part B (2) COGS				(188,800)						
Part B (3) Depreciation Building							(10,000)			
Part B (4) Equipment Lease									(20,000)	
Part B (4) Equipment Lease										92,000
Lease payment	(16,000)									
Depreciation										(11,500)
Part B (5) Income Tax	(23,505)									
Balances	7,835	99,400	(4,970)	51,000	70,000	350,000	(10,000)	80,000	(20,000)	92,000
										(11,500)

	Accounts payable	Note payable	Interest payable	Lease payable	Common stock	Retained earnings
Balances: Part A	26,440	380,000	6,650		160,000	313,450
Part B (1) Bad debts						(4,970)
Part B (2) COGS						(188,800)
Part B (3) Depreciation Building						(10,000)
Part B (4) Equipment Lease				92,000		(20,000)
Lease payment				(8,640)		(7,360)
Depreciation						(11,500)
Part B (5) Income Tax						(23,505)
Balances	26,440	380,000	6,650	83,360	160,000	47,315



**Glenwood Heating, Inc.**

**Part B: Trial Balance**

	<u>Debits</u>	<u>Credits</u>
Cash	426	
Accounts receivable	99,400	
Allowance for bad debts		994
Inventory	62,800	
Land	70,000	
Building	350,000	
Accumulated depreciation - Building		10,000
Equipment	80,000	
Accumulated depreciation - Equipment		9,000
Accounts payable		26,440
Interest payable		6,650
Note payable		380,000
Common stock		160,000
Dividend	23,200	
Sales		398,500
Cost of goods sold	177,000	
Other operating expenses	34,200	
Bad debt expense	994	
Depreciation expense - Building	10,000	
Depreciation expense - Equipment	9,000	
Rent expense	16,000	
Interest expense	27,650	
Provision for income tax	30,914	
<b>Total</b>	<b><u>\$ 991,584</u></b>	<b><u>\$ 991,584</u></b>

**Eads Heating, Inc.**  
**Part B: Trial Balance**

	<u>Debits</u>	<u>Credits</u>
Cash	7,835	
Accounts receivable	99,400	
Allowance for bad debts		4,970
Inventory	51,000	
Land	70,000	
Building	350,000	
Accumulated depreciation - building		10,000
Equipment	80,000	
Accumulated depreciation - equipment		20,000
Leased equipment	92,000	
Accumulated depreciation - leased equipment		11,500
Accounts payable		26,440
Interest payable		6,650
Note payable		380,000
Lease payable		83,360
Common stock		160,000
Dividend	23,200	
Sales		398,500
Cost of goods sold	188,800	
Other operating expenses	34,200	
Bad debt expense	4,970	
Depreciation expense - building	10,000	
Depreciation expense - equipment	20,000	
Depreciation expense - leased equipment	11,500	
Interest expense	35,010	
Provision for income tax	23,505	
<b>Total</b>	<b><u>\$ 1,101,420</u></b>	<b><u>\$ 1,101,420</u></b>

## Calculations:

### Part A:

5	$(40 \times 1,000) + (60 \times 1,100) + (20 \times 1,150) + (62 \times 1,200) + (28 \times 1,300) = 239,800$
9	$(400,000 \times .07) = 28,000 / 12 = 2,333.33 \times 9 = 21,000$
11	$7.25 \times 3,200 = 23,200$
12	$(380,000 \times .07) = 26,600 / 12 = 2,216.66 \times 3 = 6,650$

### Part B:

1	<u>Glenwood</u>	$(99,400 \times .01) = 994$
	<u>Eads</u>	$(99,400 \times .05) = 4,970$
2	<u>Glenwood</u>	$(40 \times 1,000) + (60 \times 1,100) + (20 \times 1,150) + (40 \times 1,200) = 177,000$
	<u>Eads</u>	$(28 \times 1,300) + (62 \times 1,200) + (20 \times 1,150) + (50 \times 1,100) = 188,800$
3	<u>Glenwood</u>	Building - $(350,000 - 50,000) / 30 = 10,000$
		Equipment - $(80,000 - 8,000) / 8 = 9,000$
	<u>Eads</u>	Building - $(350,000 - 50,000) / 30 = 10,000$
		Equipment - $(100\% / 8) = 12.5\% \times 2 = 25\% \times 80,000 = 20,000$
4	<u>Eads</u>	$(92,000 - 0) / 8 = 11,500$
5	<u>Glenwood</u>	$123,565 \times .25 = 30,914$
	<u>Eads</u>	$94,020 \times .25 = 23,505$

<u>Eads Income Statement</u>	
Interest expense	$27,650 + 7,360 = 35,010$
Lease payable	$92,000 - 8,640 - 9,330 = 74,030$

The University of Mississippi

ACCY 420

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# Molson Coors Brewing Company

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Jordan Haley Enlow

September 19, 2017

## Introduction:

This case study concerns the profitability and earnings persistence of Molson Coors Brewing Company, which has its largest markets in Canada, the United States, and the United Kingdom. The way this is shown is through the explanation of how classified income statements work, why comprehensive income is important, the difference between “Special items, net” and “other income (expense), net”, and how this company gets around a high effective tax rate. Also, the difference between net income and comprehensive income is shown to be important to understanding earnings persistence.

Upon starting this case study, I had no clue what Special items were, much less the difference between special items and “other income (expense), net”. This case study also helped to hammer home the idea of comprehensive income and what that entails, as well as the importance of having a measure of a company’s persistent income. I especially found the effective tax rate portion of the case study to be interesting; I did not realize that outsourcing labor to foreign countries can not only lower your labor costs, but your tax rate as well. Also, the way Molson Coors calculated net sales (using excise tax instead of sales discounts, sales returns, and allowance for damaged goods) was interesting. It made sense for this company, but excise tax would not even be applicable in any way for many other companies. This helped me to realize accounting financial statements do not always come in an absolutely preset format, and that a company can customize their statements using common sense and still be under GAAP.

I. What are the major classifications on an income statement?

Broadly speaking, an income statement contains revenues, expenses, and net income. However, it is important that we distinguish our revenues and expenses by type. The way that we accomplish this is by having a classified income statement. A classified income statement first calculates operating income by subtracting our operating expenses (which consist of expenses incurred by performing our core operations) from our net sales. Next, non-operating revenues and expenses (or gains/losses) are added or subtracted, and this gives us net income.

II. Explain why, under U.S. GAAP, companies are required to provide “classified” income statements.

It shows more details of revenues and expenses and prevents fraud. It also shows which of our incomes/expenses are likely to be recurring, as opposed to a gain or loss type of situation that may or may not reoccur ever again. By showing operating income separately, we show a pure measure of our performance as a company.

III. In general, why might financial statement users be interested in a measure of persistent income?

It is income that is consistent, i.e. your normal revenues that are reliable. It helps you have a good base number of incoming revenue with which to operate, and this helps investors feel more secure about our future cash flows. It also affects our stock prices since the forecast of our future earnings minus our perceived risk is our stock price.

IV. Define comprehensive income and discuss how it differs from net income.

Comprehensive income differs from net income in that you include unrealized gains/losses from sale securities and foreign currency exchanges in your calculations. The part of this that is most important to our company is the inclusion of gains and losses from foreign currency exchanges, since such a large part of our operations take place in foreign countries.

V. The income statement reports “Sales” and “Net Sales”. What is the difference? Why does Molson Coors report these two items separately?

Sales is purely the money we receive from the entities that purchase our product. Net sales is typically defined as sales less sales discounts, sales returns, and an allowance for damaged goods. However, we calculate net sales as being sales less excise taxes. Our thinking in substituting excise tax in the place of those things is that we see excise tax as being purely a reduction of sales. The reason these two things are reported separately is that net sales gives us our true operating revenue.

VI. Consider the income statement item “Special items, net” and the information in Notes 1 and 8.

- a. In general, what types of items does Molson Coors include in this line item?

Typically, special items include our infrequent or unusual items, impairment or asset abandonment-related losses, restructuring charges and other atypical employee related costs, or fees on termination of significant operating agreements and gains/losses on disposal of investments.

- b. Explain why the company reports these on a separate line item rather than including them with another expense item. Molson Coors classifies these special items as operating expenses. Do you concur with this classification?

Generally speaking, special items are reported separate from other items because they are meant to be ignored by investors. Our special items are not indicative to our core operations, so I feel that they should not be included in our operating expenses. For example, our cost of goods sold is listed under our operating expenses, while loss from a flood in France is listed as special items. Cost of goods sold is very obviously directly related to our operations; if we did not make the products we could not sell them. However, a hopefully one time occurrence of a flood in one of our France locations is not central to our companies operation as a whole.



- VII. Consider the income statement item “Other income (expense), net” and the information in Note 6. What is the distinction between “Other income (expense), net” which is classified as a non-operating expense, and “Special items, net” which Molson Coors classifies as operating expenses?

“Other income(expenses), net” are transactions such as a gain on the sale of equipment and a loss on a loan. Special items include employee related charges and flood loss. So, while some of the events included in our special items can arguably impact our operations, a gain on the sale of equipment cannot.

- VIII. What is the amount of comprehensive income in 2013? How does this compare to net income in 2013? What accounts for the difference between net income and comprehensive income in 2013? In your own words, how are the items included in Molson Coors’ comprehensive income related?

Our comprehensive income for 2016 is \$760,200,000, while net income is \$572,500,000. There is an \$187,700,000 difference. What accounts for this difference is items that bypass the income statement but yet still have an effect on our stockholders’ equity. The reason these things are not included on our regular income statement is that they are not necessarily recurring. For example, in 2013 we lost \$207,700,000 due to foreign currency translations, but that is not something we can control with our business decisions and it is subject to change. Also, with “Comprehensive income (loss) attributable to non-controlling interests”, we showed a loss of \$5,200,000 in 2013, whereas we had a gain of \$3,900,000 in 2012. Since we do not fully control this

company, we want our statements to show a difference in the net income that we can absolutely control, and in the net income we are somewhat at the mercy of another company of controlling.

IX. What is Molson Coors effective tax rate in 2013?

Our effective tax rate is 12.8 percent, as opposed to the statutory federal income tax rate of 35.0 percent (another 6.7 percent is added through state taxes, etc.). This rather drastic difference is due to the effect of foreign tax rates, which lower our overall tax rate by around twenty-seven percent. We are able to take advantage of this tax break by having a good amount of our operations and business dealings occur in foreign countries.

The University of Mississippi

ACCY 420

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Pearson PLC

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Jordan Haley Enlow

September 19, 2017

## Introduction:

This case study concerns the accounts receivable (trade receivable) and the respective contra accounts (Provision for Bad and Doubtful Debts and Provision for Sales Returns) of Pearson, PLC. The importance of the way in which a company estimates its bad debts and sales returns is highlighted, and the question of why a company would sell something on credit when they feel certain there will be a percentage of those credit sales that they will never collect is answered. Also discussed and analyzed (using T-accounts and journal entries) are the types of transactions that cause the difference in Trade Receivables, net and Trade Receivables, such as sales (all of Pearson's sales are credit sales), cash collections, the write-off of bad debts, and the volume of actual sales returns.

Discovering the nuances in accounting language differences between the U.S and the U.K. was something I found interesting. For example, in the U.S., an account with "provision" in its title will be an expense account, while in the U.K. the word "provision" is simply the U.K. version of what accountants refer to as "allowance" in the U.S. The idea of using the aging-of-accounts procedure to estimate bad debts was something I was only vaguely familiar with; however, this case study helped me to understand and truly think about why a company would sell on credit and how managers estimate their bad debts/sales returns. I also was not comfortable with the concept of writing off bad debts/actual sales returns from the account (trade) receivable account. Figuring out how to do this intuitively instead of trying to memorize a sequence of journal entries will be very helpful to my future work, both academically and professionally.

I. What is an account receivable? What other names does this asset go by?

An account receivable is a current asset account, meaning that its transactions are meant to be fulfilled in one year or less, that occurs when a customer purchases a product from us on credit. In other words, our company gives a product and receives a promise of future payment from the customer. Another name for account receivables that our company uses is trade receivables.

II. How do accounts receivable differ from notes receivable?

Accounts receivable differs from notes receivables in that accounts receivable are short term, while notes receivable are long term. Also, accounts receivable are incurred by the selling of a product, while notes receivable is typically a repayment of cash and accrues interest.

III. What is a contra account? What two contra accounts are associated with Pearson's trade receivables? What types of activities are captured in each of these contra accounts? Describe factors that managers might consider when deciding how to estimate the balance in each of these contra accounts.

A contra account is an account that reduces the value of a related account. For example, Pearson has two contra accounts, "Provision for Bad and Doubtful Debts" and "Provision for Sales Returns". They are both contra-asset accounts, meaning that they

have normal credit balances that will offset the normal debit balance of Accounts Receivable. “Provision for Sales Returns” captures the activities of a manager estimating Sales Returns and actual Sales Returns. Likewise, “Provision for Bad and Doubtful Debts” has activities that consist of estimating bad debts and writing off the actual amount of debts that will not be collected. When making these initial estimates, a manager might take into account historical data by looking at past years actual bad debts/sales returns and make an estimate based on that. They would also need to take into account any new businesses their company has acquired. If no past data exists, they might look at other businesses in their industry and make a prediction based upon their estimates.

- IV. Two commonly used approaches for estimating uncollectible accounts receivable are the percentage-of-sales procedure and the aging-of-accounts procedure. Briefly describe these two approaches. What information do managers need to determine the activity and final account balance under each approach? Which of the two approaches do you think results in a more accurate estimate of net accounts receivable?

The percentage-of-sales procedure uses historical data to find a flat percentage rate to multiply their accounts receivable by in order to estimate bad debts. Aging-of-accounts procedure is when the age of the accounts receivable is taken into account when the estimate of bad debts is made. For example, a company can look at past data and see that, historically, an account 90 days past due is more at risk of being a bad debt than

an accounts receivable transaction that happened the day before. Under the percentage-of-sales approach, a manager simply needs enough past data to find an average estimation rate and a total accounts receivable number. However, for the aging-of-accounts approach, a manager must have access to a break-down of their accounts receivable by age, as well as the historical data for how often each time period bracket defaulted on their payments in order to make an estimate. The aging-of-accounts procedure is the more accurate approach of the two because while the percentage-of-sales approach better matches bad debt expense to sales, aging-of-accounts provides a more faithful estimate of the value of our accounts receivable.

- V. If Pearson anticipates that some accounts will be uncollectible, why did the company extend credit to these customers in the first place? Discuss the risks that managers must consider with respect to accounts receivable.

Firstly, if our company never took a risk on selling to people on credit, we would only accept cash sales. This would drastically reduce the volume of our transactions and thus our profits, provided we at least collect enough of our receivables to cover our cost of goods sold for the goods sold on credit. However, it is common place for a business's managers to require customers to fill out a credit application with a list of other vendors with whom said customer has credit relationships. This helps to determine the credit worthiness of any new customers; naturally when dealing with a returning customer of our own, we can look at their past repayment habits concerning our own services. If a

customer is determined to have a poor credit history, management must take that into account when selling to this customer on credit.

VI. Note 22 reports the balance in Pearson’s provision for bad and doubtful debts and reports the account activity during the year ended December 31, 2009. Note that Pearson refers to the trade receivables contra account as a “provision”. Under U.S. GAAP, the receivables contra account is typically referred to as an “allowance” while the term provision is used to describe the current-period income statement charge for uncollectible accounts.

a. Use the information in Note 22 to complete a T-account that shows the activity in the provision for bad and doubtful debts account during the year. Explain, in your own words, the line items that reconcile the change in account during 2009.

<u>Provision for Bad and Doubtful Debts</u>	
	72,000,000 — Beginning balance
Exchange differences — 5,000,000	26,000,000 — Income statement movements
Utilized — 20,000,000	3,000,000 — Acquisition through business combination
	<u>76,000,000 — Ending balance</u>

“Exchange differences” of \$5,000,000 refers to the loss caused by translating one currency into another with inconsistent exchange rates, and “Utilized” is where management writes off the specific accounts that they have determined to be in default.



“Income statement movements” is management’s initial estimate of bad debts expense, and “Acquisition through business combination” is the estimate of bad debts expense that we assumed from another business that our company acquired.

- b. Prepare the journal entries that Pearson recorded during 2009 to capture 1) bad and doubtful debts expense for 2009 and 2) the write-off of accounts receivable during 2009. For each account in your journal entry, note whether the account is a balance sheet or income statement account.

1	Bad and Doubtful Debts Expense (I/S account)	26,000,000
	Provision for Bad and Doubtful Debts Expense (I/S account)	26,000,000
2	Provision for Bad and Doubtful Debts Expense (I/S account)	20,000,000
	Trade Receivable (B/S account)	20,000,000

- VII. Where in the income statement is the provision for bad and doubtful debts included?

It is included in the condensed operating expenses line of our income statement.

VIII. Note 22 reports that the balance in Pearson’s provision for sales returns was £372,000,000 at December 31, 2008 and £354,000,000 at December 31, 2009. Under U.S. GAAP, this contra account is typically referred to as an “allowance” and reflects the company’s anticipated sales returns.

- a. Complete a T-account that shows the activity in the provision for sales returns account during the year. Assume that Pearson estimated that returns relating to 2009 Sales to be £425,000,000. In reconciling the change in the account, two types of journal entries are required, one to record the estimated sales returns for the period and one to record the amount of actual book returns.

<u>Provision for Sales Returns</u>	
	372,000,000 — Beginning balance
	425,000,000 — Estimated sales returns
Actual sales returns (plug in number) —	443,000,000
	<hr/>
	354,000,000 — Ending balance

- b. Prepare the journal entries that Pearson recorded during 2009 to capture, 1) the 2009 estimated sales returns and 2) the amount of actual book returns during 2009. In your answer, note whether each account is a balance sheet account or an income statement account.

1	Sales Returns and Allowances (I/S account)	425,000,000
	Provision for Sales Returns (I/S account)	425,000,000
2	Provision for Sales Returns (I/S account)	443,000,000
	Trade Receivable (B/S account)	443,000,000

- IX. In which income statement line item does the amount of 2009 estimated sales returns appear?

Typically, Provision for Sales Returns would be shown under Sales on the income statement, thus producing net sales. However, our provision for sales returns is included in our calculation of net trade receivables, so it is included in the operating expenses portion of our income statement

- X. Create a T-account for total or gross trade receivables. Analyze the change in this T-account between December 31, 2008 and 2009. Assume that all sales in 2009 were on account. That is, they are all “credit sales”. You may also assume that there were no changes to the account due to business combinations or foreign exchange rate changes. Prepare the journal entries to record the 1) sales on account and 2) accounts receivable collection activity in this account during the year.

<u>Trade Receivable</u>	
Beginning balance — 1,474,000,000	
Sales — 5,624,000,000	5,216,000,000 — Cash collection (plug in number)
	20,000,000 — Write-off of bad debts
	443,000,000 — Actual sales returns
Ending balance — 1,419,000,000	

1	Trade Receivable	5,624,000,000	
	Sales		5,624,000,000
2	Cash	5,216,000,000	
	Trade Receivable		5,216,000,000

The University of Mississippi

ACCY 420

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Palfinger AG

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Jordan Haley Enlow

November 8, 2017

## Introduction:

In this case study, the property, plant, and equipment of Palfinger AG is discussed with great detail. From identifying what types of property, plant, and equipment this company would have, to contrasting the differences between a capital expenditures approach and a revenues expenditures approach to repairing assets, to a thorough discussion of depreciation methods and the differing impacts of each method on net income. Also discussed is why “Prepayments and assets under construction” is not subjected to accumulated depreciation and the trade-off companies face when determining which depreciation method best suits their company. How to record government grants issued for the purchase of PPE is also explored.

I learned many things from studying Palfinger AG. For example, I did not realize that no matter which depreciation method you use, straight-line or double-declining balance, in the end the overall effect on net income is the same under both methods. Initially, I mistakenly did not account for depreciation expense when calculating the total effect on net income under the two methods, but upon reflecting on the process I had used I realized my mistake. Then the end numbers made more sense to me on an intuitive level. Additionally, I struggled with how the salvage value fit in to the double declining balance method of depreciation at first, but looked to Wiley’s Intermediate Accounting and promptly realized it should be left out of depreciation expense calculations. Lastly, the research on how to record assets bought with government grants was especially interesting, as I had wondered in previous work related situations how to account for government grants, and where the receipt of such things would be reported.

- I. Based on the description of Palfinger above, what sort of property and equipment do you think the company has?

Considering the type of merchandise Palfinger produces and sells, the company would have a lot of moving equipment, production machinery, large warehouses, and a good deal of land on which to build these warehouses.

- II. The 2007 balance sheet shows property, plant, and equipment of €149,990,000. What does this number represent?

In general, items reported in property, plant, and equipment (PPE) are physical assets that are used in operations. In the notes to the financial statements, the columns included in Palfinger's calculation of PPE are as follows: Land and Buildings, Undeveloped, Plant and Machinery, Other plant fixtures, fittings, & equipment, and Prepayments & assets under construction.

- III. What types of equipment does Palfinger report in notes to the financial statements?

This is found in the "Accounting and Valuation Principles" section of the notes.

According to these notes, Palfinger reports equipment that they own, the equipment that they lease, and the equipment they purchased with government grants.

- IV. In the notes, Palfinger reports “Prepayments and assets under construction.” What does this subaccount represent? Why does this account have no accumulated depreciation? Explain the reclassification of €14,958,000 in this account during 2007.

This account represents the expansion projects currently underway by Palfinger, or more specifically the buildings currently under construction. This account does not have accumulated depreciation because the rule is that a company should only depreciate the assets that are available for their use. Since a building currently under construction is not available for use, the items in this subaccount have no. They reclassified the amount of €14,958,000 because they completed the construction project.

- V. How does Palfinger depreciate its property and equipment? Does this policy seem reasonable? Explain the trade-offs management makes in choosing a depreciation policy.

Palfinger uses straight line depreciation. This policy considers depreciation a function of time instead of a measure of machine usage. Assuming the demand for Palfinger’s products is reasonably constant, then it would make more sense to depreciate the equipment based off of years of life rather than machine hour usage. Under straight-line depreciation, the effect on net income is the same for every year of the useful life. Under double-declining balance, depreciation has a disproportionate effect on net



income throughout the assets useful life. Essentially, using this method means net income will be lower for the beginning years than it will be under the straight-line method. However, the benefit in the double-declining method is the small effect on net income depreciation expense has in later years.

- VI. Palfinger routinely opts to perform major renovations and value-enhancing modifications to equipment and buildings rather than buy new assets. How does Palfinger treat these expenditures? What is the alternative accounting treatment?

According to the notes on financial statements, replacement and value enhancing investments are capitalized and then depreciated over the newly calculated useful life or the original useful life. Either you can capitalize the enhancements to the assets, or you can expense them immediately with a revenue expenditure approach.

- VII. Use the information in the financial statement notes to analyze the activity in the “Property, plant and equipment” and “Accumulated depreciation and impairment” accounts for 2007. Determine the following amounts:

- a. The purchase of new property, plant and equipment in fiscal 2007.

This number is found in the “Additions” row, and is €61,444,000; this number consists of Land and Buildings of €12,139,000, plus Undeveloped of €2,020,000, plus Plant and Machinery of €15,612,000, plus Other plant fixtures, fittings, and equipment of €10,673,000, plus Prepayments and assets under construction of €21,000,000.

- b. Government grants for purchases of new property, plant and equipment in 2007. Explain what these grants are and why they are deducted from the property, plant, and equipment account.

You can account for these grants in one of two ways: set it up as deferred income or deduct it from the carrying value of the assets in question.

Palfinger uses the latter method, as evidenced by the subtraction of government grants from “Land and Equipment” and “Plant and machinery” in the amounts of €417,000 and €316,000, respectively. Total government grants for purchases of new PPE are  $€417,000 + €316,000 = €733,000$ .

- c. Depreciation expense for fiscal 2007.

According to the notes to the financial statements, the depreciation expense for 2007 is €12,557,000. This includes the depreciation of Land and Buildings, Undeveloped, Plant and Machinery, other plant fixtures, fittings, & equipment, and Prepayments and assets under construction.

- d. The net book value of property, plant, and equipment that Palfinger disposed of in fiscal 2007.

The net book value of disposals in 2007 is the total acquisition cost of the PPE being disposed of less the depreciation on these items, which according to the notes would be  $\text{€}13,799,000 - \text{€}12,298,000 = \text{€}1,501,000$ . It is important to note that the number for “Disposals” in the “Accumulated depreciation and impairments” section of the notes is the number to be used in this calculation.

- VIII. The statement of cash flows (not presented) reports that Palfinger received proceeds on the sale of property, plant, and equipment amounting to  $\text{€}1,655,000$  in fiscal 2007. Calculate the gain or loss that Palfinger incurred on this transaction. Explain what this gain or loss represents in economic terms.

If Palfinger sold the PPE they disposed of for  $\text{€}1,655,000$  they should book a “gain on disposal” of  $\text{€}154,000$ . The reason for this is that since the carrying value of the PPE being disposed of was  $\text{€}1,501,000$ , and they sold the PPE for more than what it was worth at  $\text{€}1,655,000$ , the amount “gained” from this sale was  $\text{€}154,000$  ( $1,655,000 - 1,501,000 = 154,000$ ).

IX. Consider the €10,673,000 added to “Other plant, fixtures, fittings, and equipment” during fiscal 2007. Assume that these net assets have an expected useful life of five years and a salvage value of €1,273,000. Prepare a table showing the depreciation expense and net book value of this equipment over its expected life assuming that Palfinger recorded a full year of depreciation in 2007 and the company uses:

a. Straight-line depreciation.

The method for calculating straight line depreciation involves taking the asset’s value, subtracting the salvage value from that number, and then dividing the difference by the number of estimated useful years of the asset.

The amount of depreciation is the same for every year, as shown in the depreciation chart below. (Numbers in 000s)

Year	Asset’s Value	Annual Depreciation	Accumulated Depreciation	Net Book Value
2007	10,673	1,880	1,880	8,793
2008	8,793	1,880	3,760	6,913
2009	6,913	1,880	5,640	5,033
2010	5,033	1,880	7,520	3,153
2011	3,153	1,880	9,400	1,273

b. Double-declining-balance depreciation.

The double-declining method yearly depreciation amount is found by multiplying the straight-line depreciation rate by two, which in this case is 40 percent. This leads to the depreciation number being different throughout the years of useful

life, as seen in the chart below. It is important to note that the rate is multiplied by the assets carrying value for each year. For example, in 2008,  $6,404,000 * .40 =$  (Numbers in 000s)

Year	Assets Value	Annual Depreciation	Accumulated Depreciation	Net Book Value
2007	10,673	4,269	4,269	6,404
2008	6,404	2,562	6,831	3,842
2009	3,842	1,537	8,368	2,305
2010	2,305	922	9,290	1,383
2011	1,383	110	9,400	1,273

X. Assume that the equipment from part i. was sold on the first day of fiscal 2008 for proceeds of €7,500,000. Assume that Palfinger's accounting policy is to take no depreciation in the year of sale.

- a. Calculate any gain or loss on this transaction assuming that the company used straight-line depreciation. What is the total income statement impact of the equipment for the two years that Palfinger owned it? Consider the gain or loss on disposal as well as the total depreciation recorded on the equipment.

Since the company does not record depreciation in the year of sale, the book value for the equipment at the time of the sale was €8,793,000. If Palfinger then sold the equipment for €7,500,000, this means the company should book a 'loss on disposal' of €1,293,000. The journal entry for this transaction is as follows:

Cash .....	7,500,000
Loss on Disposal .....	1,293,000
Equipment .....	8,793,000

Therefore, if a loss of €1,293,000 was booked, then this would decrease net income. However, there is still depreciation expense to be considered in the amount of €1,880,000. Since both of these negatively impact net income, the total income statement impact for the two years is a deduction of €1,293,000 + €1,880,000 = €3,173,000 from income before taxes.

- b. Calculate any gain or loss on this transaction assuming the company used double-declining balance depreciation. What is the total income statement impact of this equipment for the two years that Palfinger owned them? Consider the gain or loss on disposal as well as the total depreciation recorded on the equipment.

Under the double declining method, depreciation on the assets in 2007 equals €4,269,000, so the book value of the equipment at the time of sale in 2008 is €6,404,000. The journal entry for this transaction should be as follows:

Cash.....	7,500,000
Gain on disposal.....	1,096,000
Equipment.....	6,404,000

In this case, there would be an increase to “income before taxes” of €1,096,000. However, again, there is depreciation expense to be considered. The depreciation

expense is €4,296,000, which negatively impacts net income. The overall impact on income before taxes will be  $€1,096,000 - €4,296,000 = €3,173,000$ .

- XI. Compare the total two-year income statement impact of the equipment under the two depreciation policies. Comment on the difference.

Under straight-line depreciation, a loss is booked upon the sale of the assets, while under double-declining balance method, there is a gain booked for a comparable amount. However, in the end the overall net income statement impact is the same under both methods.

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Volvo Group

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Jordan Haley Enlow

November 22, 2017



## Introduction:

This case study focused on the specifics of the research and development aspect of Volvo Group's expenditures. Firstly, R&D is defined, and then the ways in which Volvo Group decides which R&D costs to expense and which R&D costs to capitalize are discussed, along with a general discussion of IAS 38's statements concerning the capitalization of R&D costs. Later, Volvo Group is compared to an American company called Navistar concerning the proportion of net sales from manufacturing/industrial operations used to conduct research and development.

Some things that I found interesting about this case study was learning the differing ways in which companies are allowed to account R&D expenses, depending on whether or not they are under US GAAP or IFRS. As always, when looking at a company in another country, seeing the differences in the ways they do simple things such as labeling their industrialized net sales numbers was interesting. I feel that being exposed to the nuances in titles for the "same" numbers will be something that will be extremely helpful to me if I were ever employed at a large firm with international clients. Also, I felt this case study was helpful in applying the connections between the balance sheet and the income statement, as there were some calculations that required numbers from both statements to be used. Lastly, the discussion of which principle better portrays the value of the company to investors was particularly thought provoking. This case study brought to my mind the importance of knowing which accounting principle is being used when comparing two companies; while one company may have higher assets listed on their balance sheet than another, it does not necessarily mean that the company with the higher "total asset" number has any more actual value than the other.

- I. The 2009 income statement shows research and development expenses of SEK 13,193 (millions of Swedish Krona). What types of costs are likely included in these amounts?

These expenses include any costs associated with developing new product lines or improving current product lines. An example for Volvo would be research into electric cars or better safety features on existing cars. The costs included in the construction of any sort of prototype would be a part of research and development costs as well.

- II. Volvo Group follows IAS 38—Intangible Assets, to account for its research and development expenditures (see IAS 38 excerpts at the end of this case). As such, the company capitalizes certain R&D costs and expenses others. What factors does Volvo Group consider as it decides which R&D costs to capitalize and which to expense?

According to the notes to consolidated financial statements, Volvo capitalizes the R&D costs that they know with high certainty will produce future economic benefits, and the costs related to products that can be proven to be technologically functional. To expand on this answer, the excerpts from IAS 38 that are provided can be consulted. According to this, costs incurred from the research phase, such as the search of and obtainment of new knowledge, are always expensed. Development costs are also expensed unless the following six conditions are met: (1) the technical

feasibility of completing the intangible asset so that it will be available for use or sale, (2) its intention to complete the intangible asset and use or sell it, (3) its ability to use or sell the intangible asset, (4) how the intangible asset will generate probable future economic benefits, (5) the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset, (6) its ability to measure reliably the expenditure attributable to the intangible asset during its development. Only costs that meet these conditions can be capitalized and considered part of intangible assets.

- III. The R&D costs that Volvo Group capitalizes each period are amortized in subsequent periods, similar to other capital assets such as property and equipment. Notes to Volvo's financial statements disclose that capitalized product and software development costs are amortized over three to eight years. What factors would the company consider in determining the amortization period for particular costs?

According to the notes to consolidated financial statements, the company considers such things as the write-down-adjusted acquisition value of the assets in questions. Useful life is taken into account in a unit of years, since straight-line depreciation is used. Impairment tests are performed on non-current and depreciable assets only when there is an indication that the value has changed.

- IV. Under U.S. GAAP, companies must expense all R&D costs. In your opinion, which accounting principle (IFRS or U.S. GAAP) provides financial statements that better reflect costs and benefits of periodic R&D spending?

In my opinion, IFRS better reflects the costs and benefits of research and development expenditures. I believe allowing certain development costs to be capitalized provides a better picture to investors concerning the value of the company. Since only the costs that can be reasonably measured and predicted with a fair amount of certainty to generate future benefits to the company can be capitalized, companies cannot trick investors into thinking there is value where there is, in fact, none.

- V. Refer to footnote 14 where Volvo reports an intangible asset for “Product and software development.” Assume that the product and software development costs reported in footnote 14 are the only R&D costs that Volvo capitalizes.

- a. What is the amount of the capitalized product and software development costs, net of accumulated amortization at the end of fiscal 2009? Which line item on Volvo Group’s balance sheet reports this intangible asset?

The amount is SEK 25,148 less SEK 11,409, which can be found in footnote 14 in lines “Value in balance sheet 2009” of the “Intangible assets, acquisition costs” and “Accumulated depreciation and amortization”, respectively. The total amount

of capitalized cost is  $25,148 - 11,409 = \text{SEK } 13,739$ , and it is reported in the intangible asset line of Volvo Group's balance sheet.

- VI. Create a T-account for the intangible asset "Product and software development," net of accumulated amortization. Enter the opening and ending balances for fiscal 2009. Show entries in the T-account that record the 2009 capitalization (capital expenditures) and amortization. To simplify the analysis, group all other account activity during the year and report the net impact as one entry in the T-account. (Numbers in 000s)

<u>Product and Software Development, net</u>			
Beginning balance –	12,381		
Capital expenditures –	2,602	3,126	– Accumulated depreciation
		448	– Plug number
Ending balance –	11,409		

- VII. Refer to Volvo's balance sheet, footnotes, and the eleven-year summary. Assume that the product and software development costs reported in footnote 14 are the only R&D costs that Volvo capitalizes.
- Complete the table below for Volvo's Product and software development intangible asset.

(in SEK millions)	2007	2008	2009
1) Product and software development costs capitalized during the year	2,057	2,150	2,602
2) Total R&D expense on the income statement	11,059	14,348	13,193
3) Amortization of previously capitalized costs (included in R&D expense)	2,357	2,864	3,126
4) Total R&D costs incurred during the year = 1 + 2 - 3	10,759	13,634	12,669

- b. What proportion of Total R&D costs incurred did Volvo Group capitalize (as product software development intangible asset) in each of the three years?

This can be found by taking the capitalized costs for each year and dividing them by the total R&D costs incurred number for that corresponding year. For 2007, the proportion is  $2,057/10,759 = 19.12$  percent. For 2008,  $2,150/13,634 = 15.77$  percent. The 2009 percentage is the highest of the three years at  $2,602/12,669 = 20.54$  percent.

VIII. Assume that you work as a financial analyst for Volvo Group and would like to compare Volvo's research and development expenditures to a U.S. competitor, Navistar International Corporation. Navistar follows U.S. GAAP that requires that all research and development costs be expensed in the year they are incurred. You gather the following information for Navistar for fiscal year end October 31, 2007 through 2009.

(In US millions)	2007	2008	2009
Total R&D costs incurred during the year, expensed on the income statement	375	384	433
Net sales, manufactured products	11,910	14,399	11,300
Total assets	11,448	10,390	10,028
Operating income before tax	-73	191	359

IX. Use the information from Volvo's eleven-year summary to complete the following table:

(In SEK millions)	2007	2008	2009
Net sales, industrial operations	276,795	294,932	208,487
Total assets, from balance sheet	321,647	372,419	332,265

X. Calculate the proportion of total research and development costs incurred to net sales from operations (called, net sales from manufactured products, for Navistar) for both firms. How does the proportion compare between the two companies?

For Navistar, the proportion can be found by dividing the total R&D costs by the “net sales, manufactured number” given in the chart above for Navistar, which is  $375/11,910 = 3.15$  percent for 2007,  $384/14,399 = 2.67$  percent for 2008, and  $433/11,300 = 3.83$  percent for 2009. For Volvo Group, the comparable numbers can be found by dividing the total R&D costs (found in the chart for Volvo's product and software development above) by the “net sales, industrial operations” numbers found in the chart above. This gives us  $10,759/276,795 = 3.89$  percent for 2007,  $13,634/294,932 = 4.62$  percent for 2008, and  $12,669/208,487 = 6.08$  percent for 2009.

The proportions for 2007 are similar, with Navistar having a percentage of 3.15 and Volvo's percentage sitting at 3.89. However, there is a difference of 2.25 percentage points between the two companies for 2009, with Navistar spending only 3.83 percent of their net sales from manufactured (or industrial) products on research and development while Volvo allocated 6.08 percent of their net sales from industrial activities to R&D.



The University of Mississippi

ACCY 420

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Jordan Haley Enlow

January 31, 2018

## Introduction:

For this case, I was instructed to research Domo, a Business Intelligence company, and answer questions such as how it is used in general practice, the kind of technology it uses to run, what skills are necessary to utilize the software, and how the tool could impact staffing of a business. I found that this case was an excellent eye opener into the fact that I do not know enough about the different types of software available on the market, and the range of capabilities that these products have to offer businesses.

After researching Domo, which I had never heard of until this case despite the fact that they service large clients like E-Bay and MasterCard, I found the abilities of this business tool to be astounding. The way it analyzes financial data to present a more interactive report that is available on multiple types of devices was something I found very interesting. Also interesting to me was that Domo choose to make their product accessible and useful to users that do not have a financial or business background with their Magic ETL software, while still maintaining the option to make the tool more multifaceted for those users who are more advanced in their technological capabilities.

Another interesting thing about Domo is that they have their own “University” that offers classes specifically to train people in their software. These classes are offered in range of difficulty from beginner to “ExpertDomo”. After researching Domo for this case, I feel both more confident in my ability to learn about new technology, and excited to see what all technology is in store for me in my future career.

- I. Identify the history and purpose of Domo and describe, in general, how it is used to make business decisions. Be specific about what kind of technology platform it uses, etc. and other resources that need to be in place to fully utilize the functionality of Domo.

Domo was founded in 2010 by Josh James, who originally called the company Shacho, Inc. He also acquired and merged into this company a London based company called Corda; he drew heavily from Corda's technology when making the version of his technology he sells today. The question now is this: what is this technology and what purpose does it serve? The answer is that this software combines structured data, such as Professional CS software, and unstructured data, such as Facebook, and puts them together into an innovative and useful business format. This company uses the business cloud in their data compilations, which is partially what allows the software to be so flexible. In order to use this tool to its full potential, data must be uploaded to the cloud using one of their provided "connector" data sources. This program has the ability to take complex business data and make it understandable to someone with limited knowledge. However, this program also has the capacity to be quite complex and detailed for those with more understanding of how a business operates.<sup>1</sup>

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<sup>1</sup> <https://www.crunchbase.com/organization/domo>

II. What special skills are needed to use Domo to aid in business decisions making? How might a student like yourself gain those skills?

Domo can be a very user-friendly software. For example, instead of needing to know SQL to enter data into their database, if one utilized their Magic ETL technology, basically all they really have to have is the ability to drag and drop their documents in a somewhat intelligently organized manner. However, those with more of a technological background can further utilize Domo in their business. If one wished to utilize Domo to its full capabilities, they would need to know how to do the following: develop “wireframes” for business questions, bring in data files and run “Workbench” transformations, use “Fusion” to import large DataSets to Domo, use Magic ETL to perform various data transformations, such as joins, appends, and pivots, create “Beast Mode” calculations for such things as data deltas and multi-summary numbers, and lastly, conduct Magic ETL data transformations to create appended DataFlows and recursive DataFlows. A student such as I, or anyone for that matter, could acquire these skills by attending one or more of the many classes offered by Domo.<sup>2</sup>

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<sup>2</sup> [www.domo.com](http://www.domo.com)

III. How, specifically, would you use the tool in the following business settings? Create at least three specific scenarios for each category in which the tool would lead to more efficiency and/or better effectiveness. Be sure to describe what kinds of data your tool would use for each scenario.

a. Auditing:

For example, say a company has reason to believe that they have an internal issue with their cash account. Instead of hiring an auditor, the CFO can use Domo to easily analyze and get real time alerts to even slight changes in data from previous periods. The program can sift through hundreds or thousands of transactions and detect if there is a change in how cash is spent, and then send a notification accompanied by an interactive graph to the necessary people showing the change detected using the mobile app. This report can show when and where the changes took place in an easy to understand presentation.

Likewise, if a company wishes to ensure that their financial statements are without error, Domo can be used to monitor all of their account balances for material changes in percentage proportion to their previous years' data. If a member of a company's financial staff were told to check for such changes, all that would need to be done is uploading the necessary financial statements via the Magic ETL application and a comparison report selected. Again, instant notifications could be sent to various managers via the Domo mobile app for prompt discussions of the results of the report.

With technology becoming more and more of an integral part of most businesses, most companies need rigorous internal safety controls regarding the security of private data. Say a company has a reason to be concerned that their online, or even offline, data is not as secure as it should be. If this company would like to run periodic reliable, automated tests, Domo can be set up to perform rigorous safety tests on mass amounts of data Domo boasts some of the best safety controls in the marketplace, even for the data contained on their mobile apps.

b. Tax Planning:

Say a company with numerous worksites and stores wanted to evaluate the tax benefits of a different inventory method than the one they were currently using. However, say these sites were very spread out and not all of them had people comfortable with using technology. With Domo, all these people would have to do is drag and drop their spreadsheets into one of the connector programs offered by Domo, and the program can do the rest. Instead of having to transform the data themselves, all that would be necessary is for one person at the headquarters of the company to go to the connector site, select the data that had been uploaded, and request an inventory method comparison report. Domo can then provide cost of goods sold information for each inventory method in an understandable format. Next, consider a company in the UK, or in any country under IFRS standards. This company spends a lot of money in research and development. Since, under IFRS, this company can expense some research costs, this company wants to use a software to determine which of their research costs can be best linked to a

probable revenue. Domo can provide easy to understand comparisons between past successful projects and the current endeavors of the company. Domo is an excellent tool for communicating complicated financial data to professionals with all different types of backgrounds, making it the perfect tool for this scenario.

Suppose a company is wanting to decrease their taxable income by altering their method of depreciating their assets, and they are wanting to present the benefits of switching from the easier to compute straight-line method to a more complicated method, such as double declining balance, to their financial staff. Domo could be used to make a graph comparing the differing methods by uploading the value and useful life of the assets to one of their connector portals and running the desired report. This could not only make the necessary calculations to find the superior method, but also show the benefits of making the change to the staff, so that they could be better motivated to switch from the easier method.

c. Financial Statement Analysis / Valuation / Advisory:

Say an organization wants to compare a line item, such as Interest Expense, between 20 years of income statement data. Also suppose that this company has very complex statements, and that some of them are from the company's foreign operations. Domo can take these financial statements and provide instant and easy to understand comparisons while accounting for the change in currency types and currency trade rates. So, instead of needing to bring in a professional, the income statements can simply be uploaded to Domo's business cloud and the software will sift through the statements and provide accurate comparative analysis in the form of a bar graph, pie chart, etc. If more specific data is desired, the user would

simply need to select one of the numbers or sections on the chart, and the background data used in the calculations would be available to be viewed. This information is also presented in an easy to understand format, making even complex analysis questions easy to answer.

If a company wants to compare the fair value and the book value of their companywide equipment, and have their factory managers in each warehouse sell a specific type of equipment if the fair value exceed the book value. Domo can take raw data from a spreadsheet of information and present it in an easy to understand way that will eliminate the need for a financial professional to explain to the warehouse managers the accounting behind the calculations or event which pieces of equipment should be sold. With the presentation Domo will present, if these managers simply tap the desired section of the report on the mobile app, then they will be able to easily see which pieces of equipment fall into the overlap of the two desired categories needed for the company to want the item to be sold.

If a company's owner did not have a good understanding of the way a business operates in general, but wanted to be involved in making decisions, then Domo would be an excellent tool for an advisor to use in order to explain the benefits or risks of different scenarios to the owner. Say the owner wanted to know which type of entity, such as a partnership or an S-corp, would be the most profitable decision to make for that business. An advisor could make his analysis and present the pros and cons of the options to the owner in a way that would be much easier to understand than raw spreadsheets of data. The advisor could create a report comparing the tax implications, as well as the legal ramifications of any



potential lawsuits or issues of that type, and the owner would be able to clearly see the differences in any important figures.

- IV. Write a few paragraphs to your future public accounting partner explaining why your team should invest in the acquisition of and training in Domo technologies. Explain how the tool will impact the staffing and scope of your future engagements.

Domo is an extremely innovative software that lets you arrange data in most any way conceivable. It is accessible and useful to people within all ranges of technological intelligence. With its Magic ETL software, it allows users with little to no real knowledge of how a business or business software operates to run reports and upload raw data to the cloud. It also does this without limiting more advanced users, who can use what Domo dubs as “Beast Mode” to set up most any type of report. I have found in my research one of the few things that limits Domo is your own imagination.

If we invest in this software, we will be able to save cost in the long run by having the option to hire people with less technological skills than what would have been necessary without the software. The benefit to our firm in the aspect of the quality of service to our clients will increase with the purchase and implementation of this product. Domo also offers many mobile apps that will benefit the employees within our firm. With its easy to understand presentation of even the most complex financial data, this will make offering solutions to clients in a way that they can quickly comprehend astronomically easier.

The University of Mississippi

ACCY 420

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Rite Aid Corporation

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Jordan Haley Enlow

February 14, 2018

## Introduction:

This case study concerns the treatment of the long-term debt of Rite Aid Corporation. For this case, the objectives were to understand how long-term debt is accounted for and recorded in the financial statements, as well as to learn how discounts/premiums on notes and bonds payable are handled when reporting long-term debt in the financial statements. The different types of debt Rite Aid Corporation has, such as secured and unsecured debt, are explored and defined. What is meant by terms like “senior” and “guaranteed” when referring to outstanding debt is also discussed.

Multiple notes payable and their respective interest payments are calculated in a variety of ways. Specifically, Excel is used in one instance to calculate the effective interest rate on a note sold at discount given the present and face value of the note, and the cash interest payment. I found using this “RATE” tool in Excel to be very interesting, as I was unaware that Excel could serve the same purpose as a financial calculator. Also interesting to me was how the financial statement information can be used to back into calculations. For example, I was able to determine the amortized amount of the discount on a note from subtracting the unamortized amount from the previous year from the current year.

Additionally, interest rate for another note was found by figuring out the interest expense as a plug number and then dividing it by the previous period face value of the note. The amount of ways that the numbers in the financial statements can be manipulated is fascinating. As always, I feel this case study will be helpful to me and my career path in the future. I feel that knowing how to take what information you are given and back into other necessary calculations is a key part of the accounting profession.

I. Refer to the Rite Aid Corporation financial statements. All numbers are in 000s. Consider the various type of debt described in note 11, Indebtedness and Credit Agreement.

a. Explain the difference between Rite Aid's secured and unsecured debt. Why does Rite Aid distinguish between these two types of debt?

Secured debt means that some asset has been offered as collateral against the money borrow, such as a mortgage on a house. Unsecured debt is not backed in this way, and therefore typically has a higher interest rate. The reason for distinguishing between these types of debt in the notes is that it is important for investors to realize that some of the assets of the company may be at stake if Rite Aid defaults on certain debts.

b. What does it mean for debt to be "guaranteed"? According to note 11, who has provided guarantee for some of Rite Aid's unsecured debt?

A debt is said to be "guaranteed" when some third party has agreed to pay the debt in question in the event that the borrower defaults on the repayment.

According to note 11, Rite Ai's wholly-owned subsidiaries (meaning Rite Aid owns 100 percent of the subsidiary) guarantee all of the company's unsecured debt. Also, it is important to note that Rite Aid places restrictions on how much unsecured debt can be outstanding at a given time.

c. What is meant by the terms “senior”, “fixed-rate”, and “convertible”?

Senior debt simply means that the debt in questions takes precedence over other less important, “junior” debts in terms of repayment. Fixed-rate debt means that the interest rate used to find interest expense will remain constant regardless of the prevailing market interest rate. Convertible debt, usually in the form of a bond, can be converted to a predetermined number of shares of the company’s stock by the bond holder. Typically, the bond holder has the option to do this at any point over the life of the bond.

d. Speculate as to why Rite Aid has many different types of debt with a range of interest rates.

One reason for diversifying types of debt within a company is because each type of debt has its perks. For example, unsecured debt usually has a higher interest rate relative to the amount of debt principal borrowed, but it is not required to be backed by an asset. However, secured debt, while having to be backed by an asset, not only is usually offered at lower interest rate, but it allows for larger amounts of money to be borrowed at once.

II. Consider note 11, Indebtedness and Credit Agreement. How much total debt does Rite Aid have at February 27, 2010? How much of this

is due within the coming fiscal year? Reconcile the total debt reported in note 11 with what Rite Aid reports on its balance sheet.

According to note 11, Rite Aid's total debt equals \$6,370,899. While this number cannot be pulled directly from the balance sheet, it is made up of components from the balance sheet. \$6,185,633 of the total comes from the long-term debt, less current maturities, of the company. Since the number given on the balance sheet separates out the current portion of the debt, it must be added back in to find the right total. The amount of current debt is \$51,502, bringing our total to \$6,237,135. The other \$133,764 needed for our total can be found under the Lease financing obligations, less current maturities line item. The reason that this is included in total debt is that the company capitalizes the leased items, and therefore must record the money "owed" on the assets as a liability. The amount due this year is \$51,502, which represents the current (1 year or less) portion of the total debt.

III. Consider the 7.5 percent senior secured notes due March 2017.

a. What is the face value of these notes? How do you know?

These notes have a face value of \$500,000. It can be determined that the note was issued at par because not only did the carrying value of the note did not change from 2009 to 2010, but there is also no discount or premium mentioned in the notes.

- b. Prepare the journal entry that Rite Aid must have made when these notes were issued.

Since the notes were issued at par, there is no discount or premium to be accounted for and the company received the face value of the note in cash.

- This entry increases assets (cash) by \$500,000, increases liabilities (notes payable) by \$500,000, and has no effect on net income.

Cash .....	500,000
Notes Payable .....	500,000

- c. Prepare the annual interest expense journal entry. Note that the interest paid on a note during the year equals the face value of the note times the stated rate of the note.

Since this note has a 7.5 percent stated, or face rate, the interest expense for each year will be  $(\$500,000 * .075) = \$37,500$ . The entry to record this expense is as follows:

- This entry has no effect on assets, increases liabilities by \$37,500 (interest payable), and decreases net income by increasing interest expense by \$37,500.

Interest Expense .....37,500

Interest Payable .....37,500

- d. Prepare the journal entry that Rite Aid will make when these notes mature in 2017.

Again, since this note was issued at par, the original face value of note will be repaid in full upon maturity.

- This entry decreases assets (cash) by \$500,000, decreases liabilities (notes payable) by \$500,000, and has no effect on net income.

Notes Payable .....500,000

Cash .....500,000

- IV. Consider the 9.375 percent senior notes due December 2015. Assume that interest is paid annually.

- a. What is the face value of these notes? What is the carrying value of these notes at February 27, 2010? Why do the two values differ?

The face value of these notes is given in note 11 as being \$410,000. However, the carrying value in this instance differs from the face value because the carrying value of notes is found by subtracting the discount from/adding the premium to the face value. In this case, it is stated in note 11 that there is a discount on these notes, which is given to us as being \$4,049 for this year. Therefore, the carrying



value is  $(\$410,000 - 4,049) = \$405,951$ , which matches the number found in note 11 for the 2010 value of these notes.

b. How much interest did Rite Aid pay on these notes during the fiscal 2009?

The actual amount of cash paid toward interest can be found by multiplying the face value of the note by the stated rate, which for these notes is  $(\$410,000 * .0937) = \$38,438$ .

c. Determine the total amount of interest expense recorded by Rite Aid on these notes for the year ended February 27, 2010. Note that there is a cash and a noncash portion of interest expense on these notes because they were issued at a discount. The noncash portion of interest expense is the amortization of the discount during the year.

As stated above, there is a noncash portion of interest expense that must be amortized. This amount can be found by a quick analysis of the unamortized discount numbers given in note 11. It is stated that the amount of unamortized discount recorded for each year is \$4,049 for 2010 and \$4,754 for 2009. To find the amortized amount for the year, simply find the difference between the two numbers, which is \$705. This number represents the Discount on Notes Payable, and this number must be added to the cash interest paid on the notes (calculated above) to find total interest expense for the year. Therefore, total interest expense is  $(\$38,438 + \$705) = \$39,143$ .

d. Prepare the journal entry to record interest expense on these notes for fiscal 2009. Consider both the cash and discount (noncash) portions of the interest expense from above.

- This entry decreases assets (cash) by \$38,438, increases liabilities by decreasing discount on notes payable, which is a contra-liability account, by \$705, and decreases net income by increase interest expense by \$39,143.

Interest Expense .....39,143

Discount on Notes Payable .....705

Cash .....38,438

e. Compute the total rate of interest recorded for fiscal 2009 on these notes.

To find the total, or effective, interest rate for 2009, the total interest expense incurred must be divided by the beginning of the year carrying value of the notes. The reason for this is that if given the effective rate, the analysis of note 11 above is unnecessary, because the carrying value can simply be multiplied by the effective rate to find total interest expense. Therefore, \$405,246 times some rate will result in the total interest expense number of \$39,143. After solving, this rate is found to be  $(\$39,143/\$405,246) = 9.659$  percent.

V. Consider the 9.75 percent notes due June 2016. Assume that Rite Aid issued these notes on June 30, 2009 and that the company pays interest on June 30<sup>th</sup> of each year.

- a. According to note 11, the proceeds of the notes at the time of the issue were 98.2 percent of the face value of the notes. Prepare the journal entry that Rite Aid must have made when the notes were issued.

If the note was issued at 98.2 percent, this means that there is a discount on the note of 1.8 percent, or  $(\$410,000 * .018) = \$7,380$ . Therefore, the journal entry is as follows:

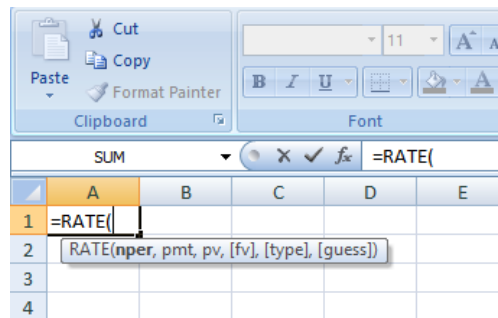
- This entry increases assets (cash) by \$402,620, decreases liabilities by increasing discount on notes payable, which is a contra-equity account, by \$7,380, and also increases liabilities in the form of a \$410,000 notes payable. There is no effect on net income.

Cash .....	402,620
Discount on Notes Payable .....	7,380
Notes Payable .....	410,000

- b. At what effective annual rate of interest were these notes issued?

The effective annual rate can be easily found by using either a financial calculator or Excel. An example of the Formula needed to find the rate using Excel is as follows, the RATE formula is used where “nper” would be the number of periods

(7), “pmt” would be the cash payment (\$-39,975), “pv” would be the cash proceeds (\$402,620), and “fv” would be future value (\$-410,000). “type” and “guess” are not needed for this calculation, and the rate comes out as being 10.1212 percent.



- c. Assume that Rite Aid uses the effective interest rate method to account for this debt. Use the table that follows to prepare an amortization schedule for these notes. Use the last column to verify that each year’s interest expense reflects the same interest rate even though the expense changes.

Date	Interest Payment	Interest Expense	Bond Disc. Amortization	Net Book Value of Debt	Effective Interest Rate
6/30/2009				\$402,620	10.1212%
6/30/2010	\$39,975	\$40,750	\$775	\$403,395	10.1212%
6/30/2011	\$39,975	\$40,828	\$853	\$404,248	10.1212%
6/30/2012	\$39,975	\$40,915	\$940	\$405,188	10.1212%
6/30/2013	\$39,975	\$41,010	\$1,035	\$406,223	10.1212%
6/30/2014	\$39,975	\$41,115	\$1,140	\$407,362	10.1212%
6/30/2015	\$39,975	\$41,230	\$1,255	\$408,617	10.1212%
6/30/2016	\$39,975	\$41,357	\$1,382	\$409,999	10.1212%

- d. Based on the above information, prepare the journal entry that Rite Aid would have recorded February 27, 2010, to accrue interest expense on these notes.

At first glance, it would appear that the numbers needed for this entry could be taken directly from this table. However, the entry for February 27, 2010 will have accrued interest for eight months, and not twelve, at the time of payment.

Therefore, the numbers in the table must be prorated; all numbers should be multiplied by 8/12. To prorate interest expense, take  $(\$40,750 * 8/12) = \$27,167$ , for the discount take  $(\$775 * 8/12) = \$517$ , for interest payable take the interest payment of  $(\$39,975 * 8/12) = \$26,650$ .

- This entry has no effect on assets, increases liabilities (notes payable) by \$26,650, and also increases liabilities by decreasing discount on notes payable, which is a contra-liability account, by \$517. Net income decreases by \$27,167 because interest expense increased.

Interest Expense .....	27,167
Discount on Notes Payable.....	517
Interest Payable .....	26,650

- e. Based on your answer above, what would be the net book value of the notes at February 27, 2010?

Based off of the above calculations, the book value would be the face value plus the amortized discount for the year,  $(\$402,620 + \$517) = \$403,137$ . However, this does not match the carrying value of the note as described in note 11. The reason for this discrepancy is that Rite Aid used the straight-line method when calculating the book value.

The University of Mississippi

ACCY 420

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Merck and Co, Inc.

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Jordan Haley Enlow

February 23, 2018

## Introduction:

This case concerns itself with Merck and Co, Inc. and their common and treasury stocks. The stated learning objectives for this case were to explain why a company might pay dividends as well as determining why a company might repurchase their own shares. Another aspect of this case calls for the analysis of various dividend ratios, such as dividend yield (dividends per share to stock price) and dividend payout (dividends paid to net income). The differences between shares outstanding, shares authorized, and shares issued are also explored. The definition of treasury stock as well as Merck and Co's method of recording their treasury stock is discussed.

Something I found interesting about this case was fully understanding what the difference is between cost and par value methods of accounting for treasury stock, and the way that the cost method basically restates par value of the stocks that are repurchased. Another thing I found interesting was that in the computation of the dividends paid in 2007, numbers had to be taken from both the Statement of Retained Earnings and the Statement of Cash Flows. This case study also lead me to investigate dividend theory in general, which ended up being very informative and thought-provoking concerning the idea of the perceived value of a company to investors.

I feel that the concepts explored in this case study will prove to be beneficial to me in my career because, as usual it involved analysis of financial statements and understanding how numbers from multiple statements are connected with each other.



I. Consider Merck's common shares.

- a. How many common shares is Merck authorized to issue?

According to Merck's balance sheet, the company is authorized to issue 5,400,000,000 shares.

- b. How many common shares has Merck actually issued at December 31, 2007?

Also according to the balance sheet, Merck has issued shares in the amount of 2,983,508,675.

- c. Reconcile the number of shares issued at December 31, 2007, to the dollar value of common stock reported on the balance sheet.

The amount of dollar value for the common stock shares for Merck can be found by adding the amount of par value to the amount of paid in capital in excess of par, or  $(\$29.8 + \$8,014.9) = \$8,044.7$ . This means that on a per share basis, the stock is valued at  $(\$8,044,700,000 / 2,983,508,675) = \$2.70$  per share.

- d. How many common shares are held in treasury at December 31, 2007?

The number of common shares in treasury can be found on the balance sheet, and the number is 811,005,791 shares for 2007.

- e. How many common shares are outstanding at December 31, 2007?

Common shares outstanding cannot be pulled directly from the balance sheet, however, it can be found by subtracting the amount of treasury stock in 2007 from the amount of shares issued for 2007. According to the numbers found above, this

figure will come out to be  $(2,983,508,675 - 811,005,791) = 2,172,502,884$  shares outstanding.

f. At December 31, 2007, Merck's stock price closed at \$57.61 per share.

Calculate the total market capitalization of Merck on that day.

Market capitalization can be found by multiplying the number of shares outstanding by the market price per share, which in this case is  $(2,172,502,884 * \$57.61) = \$125,157,891,147$

II. Why do companies pay dividends on their common or ordinary shares? What normally happens to a company's share price when dividends are paid?

One reason a company might pay dividends is that it sends a signal to the market as a whole that the company is indeed making a profit, and is not being untrue in their financial statements. Another thing that comes into play when speaking about dividends is the fact that once companies have started declaring dividends, they are reluctant to stop. This is due to the investors' perceived value of the company; management is afraid that stopping dividends will signal to investors that the company is struggling financially and is unable to pay dividends.

Typically, when a company issues "good" dividends, stock price will go up due to increased perceived value of the company. Alternatively, if a company issues dividends lower than previous dividends, or fails to pay dividends at all, this can

cause the stock price to drop due to investors thinking the company is in a worse place financially than they were previously.

III. In general, why do companies repurchase their own shares?

There are many reasons that a company might buy back their own shares. For instance, the purpose could be to simply increase their earnings per share numbers by reducing the number of shares outstanding. Another reason could be to help stock holders elude the higher tax rate at which dividends are taxed by using the money that would have otherwise been issued as a dividend to buy back stocks from investors. Along these same lines is another reason a company might repurchase their own shares, and that reason is to have enough stock to adequately fund their employee stock compensation contracts.

IV. Consider Merck's statement of cash flow and statement of retained earnings. Prepare a single journal entry that summarizes Merck's common dividend activity for 2007. (In millions)

Retained Earnings .....	3,310.7	(This number comes from the Statement of R/E)
Dividends Payable .....	3.4	(Dividends increased)
Cash .....	3,307.3	(Found in the financial section of the Statement of Cash Flows)

V. During 2007, Merck repurchased a number of its own common shares on the open market.

a. Describe the method Merck uses to account for its treasury stock transactions.

According to note 11 on the balance sheet, Merck uses the cost method to account for its treasury stock. This means that the stock is recorded in the treasury stock account at the price of the shares instead of the par value of the shares; par value never comes into play when using the cost method. Also, this amount is deducted from both the paid-in-capital account and retained earnings.

b. Refer to note 11 to Merck's financial statements. How many shares did Merck repurchase on the open market during 2007?

The number of net purchases was increased by 607.3 million shares of treasury stock during 2007. The total number of treasury stock purchased can be found on the Statement of Retained Earnings; it is 26,500,000.

c. How much did Merck pay, in total and per share, on average, to buy back its stock during 2007? What type of cash flow does this represent?

According to the Statement of Cash Flows, the total amount spent to repurchase share in 2007 was \$1,429.7 million. Per share, considering the Statement of Retained Earnings states that the number of share purchased was 26.5 million, this comes out to be  $(1,429.7/26.5) = \$53.95$ . This represents a financing activity,

which can be defined as a cash flow that deals with external activity such as raising capital or repaying investors.

d. Why doesn't Merck disclose its treasury stock as an asset?

An asset is defined as a probable future economic benefit that is obtained or controlled by a particular entity as a result of a past transaction or event. In other words, in order to classify something as an asset, it must be certain that this thing will indeed provide an economic benefit to the company in the future. Treasury stock is not an asset by this definition, and it in fact reduces net assets in the form of a cash reduction from the purchase.

VI. Determine the missing amounts and calculate the ratios in the table below. Use dividends paid rather than dividends declared in your calculations. Use the number of shares outstanding at year end for per-share calculations. What differences do you observe in Merck's dividend-related ratios across the two years.

Merck		
	2007	2006
Dividends paid	\$ 3,307,300,000	\$3,322,600,000
Shares outstanding	2,172,502,884	2,167,785,445
Net income	\$3,275,400,000	\$4,433,800,000
Total assets	\$48,350,700,000	\$44,569,800,000
Operating cash flows	\$6,999,200,000	\$ 6,765,200,000
Year-end stock price	\$57.61	\$41.94
Dividends per share	\$1.52	\$1.53
Dividend yield	0.026	0.037
Dividend payout	1.01	0.75
Dividends to total assets	0.068	0.075
Dividends to operating cash flows	0.47	0.49

While the amount of dividends paid decreased by several million dollars from 2006 to 2007, the amount of dividends paid per share only decreased by one cent. However, net income dropped in 2007 by over one billion dollars. This decrease in net income without a significant decrease in dividends paid explains why the dividend payout ratio increased by 33 percent. Also, although stock price increased in 2007, dividends per share did not increase, which explains the drop in dividend yield.

The University of Mississippi

ACCY 420

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State Street Corporation

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Jordan Haley Enlow

April 4, 2018

## Introduction:

This case study looks at a major financial holding company: State Street Corporation. A learning objective stated for this case was to know how to distinguish between differing types of securities, namely trading, available-for-sale, and held-to-maturity securities. Another objective was to interpret footnotes concerning these investments and to analyze said security accounts. Lastly, learning how to prepare journal entries for the sales, purchases, and fair value adjustments of these securities when applicable was stated as an objective.

To this end, trading, available-for-sale, and held-to-maturity securities are discussed in much detail throughout the case. They are defined, contrasted, and the journal entries for each scenario mentioned above are presented. Realized versus unrealized gains are discussed concerning available-for-sale securities, and amortized cost is discussed thoroughly in the case of the held-to-maturity securities. Lastly, the way in which the available-for-sale securities that were sold at a gain were accounted for was determined and an entry was prepared.

Once again, there is an issue of variation from the textbook defined “normal” name of things, with State Street presenting a “Consolidated Statement of Condition” that is clearly their balance sheet. I had never seen a balance sheet referred to in this way before, so I found it interesting to further realize that there is no end to the nuances of accounting in practice. Similarly, it was discussed how the Statement of Cash Flows for this company would differ from the “norm” because of the type of activities that make up the company’s daily operations. I truly feel that being exposed to this type of thing will be very beneficial to me in the future.



I. Consider trading securities. Note that financial institutions such as State Street typically call these securities “Trading account assets.”

a. In general, what are trading securities?

Trading securities can be either a debt investment or an equity investment. These are typically purchased with the intent to sell them within a year or less (usually within three months). Because of this, trading securities are typically recorded at fair value and adjusted for fair value throughout the ownership of the security.

b. How would a company record \$1 of dividends or interest received from trading securities?

Cash .....	1
Dividend Income .....	1

c. If the market value of trading securities increased by \$1 during the reporting period, what journal entry would the company record?

Fair Value Adjustment - Trading .....	1
Unrealized Holding Gain or Loss – Income .....	1

II. Consider securities available-for-sale. Note that State Street calls these, “Investment securities available for sale.”

- a. In general, what are securities available-for-sale?

Available for sale securities are debt or equity investments that a company initially records at fair value but does not record the changes in fair value to net income until after the security is sold. To achieve this effect, adjustments to the fair value during the company's ownership of the security are placed in the "Unrealized holding Gain or Loss – Equity" account.

- b. How would a company record \$1 of dividends or interest received from securities available-for-sale?

Cash .....	1
Interest Revenue .....	1

However, it is important to note that if the security was purchased at a premium or discount, the premium or discount would be amortized during this entry also. This would include a debit/credit to the "Debt Investments" account that the security was debited to when it was purchased.

- c. If the market value of securities available-for-sale increased by \$1 during the reporting period, what journal entry would the company record?

Fair Value Adjustment - AFS .....	1
Unrealized Holding Gain or Loss – Equity .....	1

III. Consider securities held-to-maturity. Note that State Street calls these, “Investment securities held to maturity.”

- a. In general, what are these securities? Why are equity securities never classified as held-to-maturity?

A held-to-maturity security is a debt security that a company intends to hold until it matures. This means that the investment is recorded at amortized cost and it is not adjusted for fair value, so there is never an entry to an “unrealized holding gain or loss” account. If the security is sold, then a realized gain or loss on the sale of the investment is recorded, if applicable. Since an equity security does not have a maturity date, they cannot be classified as held-to-maturity.

- b. If the market value of securities held-to-maturity increased by \$1 during the reporting period, what journal entry would the company record?

The company would not record an entry to adjust the investment to fair value because they intend to hold it to maturity.

IV. Consider the “Trading account assets” on State Street’s balance sheet.

- a. What is the balance in this account on December 31, 2012? What is the market value of these securities on that date?

This account can be found in the Consolidated Statement of Condition, which is what State Street calls its balance sheet. Since trading securities are recorded at fair value, the balance in the account of \$673 million is the market value of the securities.

- V. Assume that the 2012 unadjusted trial balance for trading account assets was \$552 million. What adjusting journal entry would State Street make to adjust this account to market value? Ignore any income tax effects for this part.

The entry to adjust the trading securities to their new fair value would be as follows.

Fair Value Adjustment – Trading .....	85,000,000
Unrealized Holding Gain or Loss .....	85,000,000

The amount is for \$85 million because that is how much the fair value exceeded the old value of the securities recorded on the books.

VI. Consider the balance sheet account “Investment securities held to maturity” and the related disclosures in Note 4.

a. What is the 2012 year-end balance in this account?

According to the Consolidated Statement of Condition, the amount in this account is \$11,379 million.

b. What is the market value of State Street’s investment securities held to maturity?

Also according to the Consolidated Statement of Condition, this number is stated at \$11,661 million.

c. What is the amortized cost of these securities? What does “amortized cost” represent? How does amortized cost compare to the original cost of the securities?

The amount mentioned above of \$11,379 million is the amortized cost, since held-to-maturity securities are recorded at amortized cost and not fair value. The amortized cost represents the book value of the securities, which is the original cost less or plus the premium or discount amount to have been accounted for thus far in the life of the investment.

d. What does the difference between the market value and the amortized cost represent? What does the difference suggest about how the average market rate of interest on held-to-maturity securities has changed since the purchase of the securities held by State Street?

The difference between amortized cost and market valued represents the gain or loss that would be associated with the security in question if it were sold. In this case, the fair value exceeds the amortized cost of the securities. This difference suggests that the market interest rate has most likely decreased since the investments were initially purchased.

VII. Consider the balance sheet account “Investment securities available for sale” and the related disclosures in Note 4.

- a. What is the 2012 year-end balance in this account? What does this balance represent?

The year-end balance in this account, according to the Consolidated Statement of Condition, is \$109,682. This balance is the adjusted fair value of the securities.

- b. What is the amount of net unrealized gains or losses on the available-for-sale securities held by State Street at December 31, 2012? Be sure to note whether the amount is a net gain or loss.

According to note 4, the total unrealized gains for the available-for-sale securities are \$2,001 million, and the total unrealized losses are \$882 million. Therefore, the net unrealized gain/loss is a gain for \$1,119 million.

- c. What was the amount of net realized gains (losses) from sales of available-for-sale securities for 2012? How would this amount impact State Street's statements of income and cash flows for 2012?

The net realized gains, according to note 4, are stated as \$101 million. Net losses are \$46 million. This leads to a net gain of \$55 million. While unrealized gains would flow through "Unrealized Holding Gain or Loss – Equity" for available-for-sale securities, realized gains or losses will show up in the income statement. This \$55 million can be found in the "Net gains (losses) from sales of investment securities" line on their Income Statement. The Statement of Cash Flows for this company, because it is a financial holding company, will look a little different than it usually does for other companies. The reason for this is that the lines between State Street's investing and operating activities are blurred, since investing is its operation. Therefore, the gain would show up in either the operating or investing section and would increase overall cash flows.

VIII. State Street's statement of cash flow for 2012 (not included) shows the following line items in the "Investing Activities" section relating to available-for-sale securities (in millions):

- Proceeds from sales of available-for-sale securities \$ 5,399
- Purchases of available-for-sale securities \$60,812

- a. Show the journal entry State Street made to record the purchase of available-for-sale securities for 2012.

Equity Investment – AFS .....	60,812
Cash .....	60,812

- b. Show the journal entry State Street made to record the sale of available-for-sale securities for 2012. Note 13 (not included) reports that the available-for-sale securities sold during 2012 had “unrealized pre-tax gains of \$67 million as of December 31, 2011.”

Cash .....	5,399
Unrealized Holding Gain or Loss .....	67
Realized Gain on AFS* .....	55
Equity Investment – AFS .....	5,411

\*The Realized Gain of \$55 million is calculated in the previous question.

- c. Use the information above to determine the original cost of the available-for-sale securities sold during 2012.

Since it is given that the proceeds from the sale were \$5,399 million, and it is also known that there was a \$55 million gain on the sale, the book value of the securities can be calculated. Considering that a gain is the amount of consideration in excess of the book value that is received for the asset, then the book value can be found using the following formula:  $\text{gain} = \text{consideration} - \text{book value}$ . Therefore, the book value is  $\$55 \text{ million} = \$5,399 \text{ million} - \text{BV}$ , or \$5,344 million.



The University of Mississippi

ACCY 420

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ZAGG, Inc.

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Jordan Haley Enlow

April 11, 2018

Introduction:

This case concerns ZAGG, Inc. and their treatment of deferred taxes. The learning objectives as laid out by the case, were the following: to understand the concepts underlying deferred income tax accounting, to understand and interpret the three primary disclosures provided in the income tax footnote to the financial statements, to use deferred income tax asset and liability information to infer the magnitude of differences between book and tax income and asset values, and lastly, to understand the purpose of a deferred income tax asset valuation allowance.

Firstly discussed in this case is the difference between book income and taxable income. Tax differences and the difference between statutory and effective tax rates are also discussed. The FASB's Accounting Standards Codification 740 – Income Tax was consulted in order to answer the question of why income tax expense differs from income tax payable. Deferred tax assets and deferred tax liabilities are defined and examples are given of each. The deferred income tax valuation allowance is discussed, along with when it is needed, and the effective interest rate. Lastly, the journal entries for recording income tax payable and expense are shown.

This case was challenging for me, as the Accounting Codification Standard was a bit confusing. However, I do believe that sifting through it to do this case will prove beneficial to me in the future. I found the computation of concept of the effective tax rate to be very interesting. All in all, this case study was challenging, but very interesting.

- I. Describe what is meant by the term book income. Which number in ZAGG's statement of operation captures this notion for fiscal 2012? Describe how a company's book income differs from its taxable income.

The term "book income" refers to the amount of income before taxes a company reports on its financial statements under GAAP. This number for ZAGG in 2012 can be found on the Consolidated Statement of Operations as "Income before Provision for Income Taxes", which is recorded in the amount of \$23,898. Book income differs from taxable income because the IRS has different standards of what counts as being deductible from income than does GAAP.

- II. In your own words, define the following terms:

- a. Permanent tax differences

A permanent tax will not be reversed in future years. For example, municipal bond interest will never be recognized as taxable income but is acceptable as income under GAAP.

- b. Temporary tax difference

A temporary tax difference is one that will reverse in future years, and thus result in either a deferred tax asset or a deferred tax liability. An example of this would be a difference in the depreciation method used, as some depreciation methods that are acceptable under GAAP are not acceptable for the IRS's standards.

c. Statutory tax rate

The statutory tax rate is the technical rate of tax that a business is required by law to pay. For example, if the statutory tax rate is 35 percent, then 35 percent of the company's income is due to the IRS in taxes.

d. Effective tax rate

However, with the above being said, the effective tax rate is the tax rate that corresponds to the income tax expense that companies actually pay. This rate can be calculated by dividing income tax expense by pre-tax income. The way this income tax expense is calculated is by taking the income tax as is found by multiplying the statutory rate by pre-tax income and subtracting or adding amounts as required.

III. Explain in general terms why a company reports deferred income taxes as part of their total income tax expense. Why don't companies simply report their current tax bill as their income tax expense?

In order to answer this question, firstly what is meant by "deferred income taxes" should be explained. Deferred income taxes are a result of pre-tax financial income, as defined by GAAP, differing from taxable income, as defined by the IRS. Depending on the situation, this can result in either a deferred income tax asset, or it can result in a deferred income tax liability. In simple terms, the reason deferred income taxes are included in income tax expense is that, as stated

before, the IRS and GAAP have differing standards of what a company can include in their income calculations. To this end, FASB Accounting Standards Codification 740, which concerns income taxes, was established. This standard deals with how to account for income taxes payable and the tax consequences of the following situations: (1) revenues, expenses, gains, or losses that are included in taxable income of an earlier or later year than the year in which they are recognized in financial income, (2) other events that create differences between the tax bases of assets and liabilities and their amounts for financial reporting, and lastly (3) operating loss or tax credit carrybacks for refunds of taxes paid in prior years and carryforwards to reduce taxes payable in future years. Number one in this list is referring to the idea of deferred tax amounts, and number two refers to deferred tax assets and liabilities. Number three, as stated, deals with tax refunds and a reduction of taxes in the future. The reason that companies do not report their current tax bill as their income tax expense is because of the difference between the two numbers caused by one of the three things listed above. For example, when determining the amount of income tax payable to report, companies first calculate their “income tax expense” by multiplying their pre-tax financial income by the statutory tax rate. They then add or subtract any deferred tax assets or deferred tax liabilities that might be present. This number is what represents the company’s actual amount of taxes owed to the government. If there is a deferred tax asset, this will result in a future deductible amount from taxable income in future periods, so it should add to income tax expense and make the income tax payable larger than income tax expense for the current year.

However, if there is an income tax liability, this will result in a future taxable amount. As such, this should be subtracted from the income tax expense for the company, thus reducing the income tax payable for the current year.

- IV. Explain what deferred income tax assets and deferred income tax liabilities represent. Give an example of a situation that would give rise to each of these items on the balance sheet.

A deferred income tax asset is an amount of tax paid to the government that is above what the company shows as its income tax expense for the current period. A deferred income tax liability is an amount that is deducted from the amount of income tax expense for the current period of the company. There are many reasons that a deferred tax asset or liability could occur. Specifically, a deferred tax asset could arise from unearned rent revenue. For example, say that this company has unearned rent revenue of \$500. While GAAP says that this is not counted as income, the IRS considers it to be income. Therefore, there is a future deductible amount for \$500 times the tax rate that must be added to income tax expense. Basically, the company owes more than what their books say they owe, and income tax payable is higher than the recorded expense for the period. A deferred liability, on the other hand, behaves in the opposite manner. For instance, say that a company uses the straight-line depreciation method for one of their assets. The IRS allows for other depreciation methods that reduce the value of the asset faster, so the amount of depreciation expense recorded in the company's income statement is lower than what is allowable with the IRS. This

makes net income higher than taxable income, and because of this income tax expense for the current period is “overstated” in a way. In order to fix this, a company sets up a deferred income tax liability account, which results in a future taxable amount and reduces the amount of income tax payable for the current year.

- V. Explain what a deferred income tax valuation allowance is and when it should be recorded.

A deferred income tax valuation allowance is an account that a company sets up in order to show the reduction of the value of a deferred tax asset. The instance that this account would come into play is when a company has reason to be 50 percent or more certain that they will not realize the full value of the tax asset.

- VI. Consider the information disclosed in Note 8 – Income Taxes to answer the following questions:

- a. Using information in the first table in Note 8, show the journal entry that

ZAGG recorded for the income tax provision in fiscal 2012?

According to footnote 8, “Total deferred” tax is \$8,293, and “Total (provision) benefit” is \$9,393. To find the amount of income tax payable, you need to look for the “Total current” provision, which is \$17,686. Therefore, the entry is as follows:

Income Tax Expense .....	9,393
Deferred Tax Asset, net .....	8,293
Income Tax Payable .....	17,686

- b. Using the information in the third table in Note 8, decompose the amount of “net deferred income taxes” recorded in income tax journal entry into its deferred income tax asset and deferred income tax liability components.

To find the amount of the deferred tax asset, subtract the beginning balance of the total deferred tax asset from the ending balance of the deferred tax asset, which in this case is  $\$14,302 - \$6,300 = \$8,002$ . Finding the amount of the deferred tax liability follows the same process and is  $\$1,086 - \$794 = \$291$ .

Therefore, the entry is as follows:

Income Tax Expense .....	9,393
Deferred Tax Asset .....	8,002
Deferred Tax Liability .....	291
Income Tax Payable .....	17,686

- c. The second table in Note 8 provides a reconciliation of income taxes computed using the federal statutory rate (35 percent) to income taxes computed using ZAGG’s effective tax rate. Calculate ZAGG’s 2012 effective tax rate using the information provided in their income statement. What accounts for the difference between the statutory rate and ZAGG’s effective tax rate?



To find the effective tax rate, income tax expense should be divided by total taxable income, which in this case is pre-tax income of \$23,898 plus the net deferred tax asset in footnote 8 of \$13,508, resulting in \$37,406 of taxable income. The reason this deferred tax asset is added to pre-tax income is because a deferred tax asset becomes a future deductible amount, meaning we are already paying taxes on this amount in the current year. With this being said, the effective rate can be calculated as  $9,393 / 37,406 = 25.11$  percent. The reason this number is different is than the statutory rate set by the IRS is that, again, the IRS has different standards regarding what counts as income for the current fiscal year and what does not than GAAP.

- d. According to the third table in Note 8 – Income Taxes, ZAGG had a net deferred income tax asset balance of \$13,508,000 at December 31, 2012.

Explain where this amount appears on ZAGG's balance sheet.

This amount cannot be found on a single line item in the Balance Sheet. However, it can be found by adding the current Deferred Income Tax Asset line number to the non-current Deferred Income Tax Asset line number, or  $\$6,912 + \$6,596$ , which equals the number in question of \$13,508.

The University of Mississippi

ACCY 420

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Apple, Inc.

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Jordan Haley Enlow

May 2, 2018

## Introduction:

This case study concerns Apple, Inc. and its revenue recognition under the new Accounting Standards Codification. Some of the learning objectives outlined in the case study included defining revenues and gains, as well as explaining the difference between the two, and being able to assess a company's revenue recognition process. Also outlined in the learning objectives was having an understanding of multi-element contracts and their complexities. However, much more than this is discussed in this case study. For example, a great deal concerning the new revenue recognition standard, Accounting Standards Codification 606: Revenue from Contracts with Customers, is discussed and defined in this case study.

While delving into this new standard was what I found to be the most interesting part of this case study, there were other parts I found interesting as well. For example, I found it rather exciting to look up Apple, Inc.'s most current 10-K and know where I needed to look in the document to find what I needed. Before my experience with these case studies, I would have had no clue what part of the 10-K contained the information that was needed to answer my questions.

Sifting through an ASC is always an undertaking, and this time was no different. However, while it was challenging, it was a bit easier than the last time I attempted this task. I anticipate that I will become more comfortable and competent in my dealings with Accounting Standards as I continue to work with them. I feel that the head start, if you will, that these case studies have given me in this regard will prove to be invaluable as I continue with my accounting career.

- I. In your own words, define “revenues.” Explain how revenues are different from “gains.”

Revenue is the total amount of gross sales that a company recognizes. It can be found by multiplying the total number of units sold by price per unit and does not take into account any sales returns or allowances. Apple, Inc. does not include this number on their consolidated income statement, but instead only discloses “Net Sales”. Revenues differ from gains mainly in the fact that gains arise from a peripheral activity that resulted in a favorable difference on the company’s books, and not from normal operating activities. Therefore, gains are harder to predict, and as such should be separated from revenues on financial statements. This should be done in the interest of providing more reliable information to investors concerning the likelihood of future cash inflows.

- II. Describe what it means for a business to “recognize” revenues. What specific accounts and financial statements are affected by the process of revenue recognition?

Recognizing revenue means recording the appropriate amount of revenue on the company’s current financial statements. Under the new Accounting Standards Codification 606, revenue is recognized using “The Five Step Approach”. These five steps are as follows: 1) Identify the contract with a customer, 2) Identify the performance obligations in the contract, 3) Determine the transaction price, 4)

Allocate the transaction price to the performance obligations in the contract, and  
5) Recognize revenue when (or as) the entity satisfies a performance obligation.

As far as what accounts are affected; of course any different type of revenue account, such as sales revenue, would increase along with retained earnings. Also, cash/accounts receivable will increase when the sale is recorded. Revenue accounts would affect the Income Statement, while cash and accounts receivable will affect the Balance Sheet. Finally, the increase in retained earnings will affect the Statement of Stockholder's Equity.

III. Refer to the Revenue Recognition discussion in Note 1. In general, when does Apple recognize revenue? Explain Apple's four revenue recognition criteria. Do they appear to be aligned with the revenue recognition criteria you described in part b, above?

According to Apple, Inc.'s most recent 10-K from 2017, their four revenue recognition criteria are as follows: 1) when persuasive evidence of an arrangement exists, 2) delivery has occurred, 3) the sales price is fixed or determinable, and 4) collection is probable. Basically, criteria number one means that there has to be proof of a contract between Apple, Inc. and a customer purchasing one of their products. In Apple's case, this could either mean selling to a retailer or directly to a consumer. Number two is relatively straightforward, Apple needs to have delivered the product to the customer. Criteria three states that the price outlined in the contract must either not be able to be changed, or it

must be predictable to both parties. In other words, Apple Inc. and the customer should not have any discrepancies or unknowns concerning the price involved with the purchase. Number four means that Apple should have no reason to suspect that receiving payment for their merchandise will not happen. These criteria do indeed seem to line up with the revenue recognition criteria described above, even though there are only four criteria listed on Apple's 10-K.

#### IV. What are multiple-element contracts and why do they pose revenue recognition problems for companies?

Multiple-element contracts go by several different names. For example, some companies refer to them as “bundles”, some companies refer to them as “multiple deliverables”, and other companies call them “multi-element arrangements”.

What all of these names refer to is basically a single contract that involves the sale of several different types of products. Often times, a company selling products in bundles offer a discount on certain products within the bundle. The reason that these types of contracts can cause issues as far as revenue recognition is concerned is that it is sometimes hard to assign the correct amount of revenue to the appropriate product within the bundle. Similarly, different parts of the contracted sale may meet requirements for revenue recognition before other parts, which leaves the awkward situation of needing to recognize revenue for only one portion of a contract and not the whole contract.

V. In general, what incentives do managers have to make self-serving revenue recognition choices?

If a manager records high revenues for their department, this reflects favorably on them personally. Incentives to record as much revenue as possible could come in the form of a promotion, a raise, stock options, or simply having their achievements recognized. However, managers must be sure not to let their personal best interests cloud their judgements on the correct way to properly record revenues, as this could be detrimental to the company in the long run.

VI. Refer to Apple's revenue recognition footnote. In particular, how should the company recognize revenue for the following types of sales under ASC 606?

a. iTunes songs sold online.

Apple refers to iTunes songs in their 10-K as “third-party digital content”, and as such states that they do not set the prices for this content, nor are they the primary obligator to the customer for these products. Under ASC 606: Example 48A – “Entity is a Principal and Agent in the Same Contract”, this means that Apple operates as an agent in this instance. Therefore, the company should account for any iTunes song sales with net revenue numbers.

- b. Mac-branded accessories such as headphones, power adaptors, and backpacks sold in the Apple stores. What if the accessories are sold online?

Whether sold online or sold in stores, these products should be accounted for as revenue from regular sales. Unless it is the case that with the contracts entered into online Apple is considered an agent in the transaction, then that would change the accounting. At that point, the revenue would need to be recorded at net numbers, as stated above. However, in most cases with Apple's online sales, Apple operates as the principal. As such, under ASC 606, the revenue from these products should be recognized following The Five Step Plan outlined above.

- c. iPods sold to a third-party reseller in India.

According to Apple's 2017 10-K, when Apple sells to a third-party, they still control the pricing of their products, retain inventory risks for the products, and is the primary obligator to the customer. Therefore, Apple is considered the principal in this situation. As such, according to ASC 606: Example 47 – "Promise to Provide Goods or Services", Apple should recognize revenue in the gross amount of consideration to which it is entitled from the customer.

- d. Revenue from gift cards.

According to the 'Customers Unexercised Rights' section of ASC 606, upon the sale of a gift card, Apple Inc. should record this amount as a liability. The reason



for this is that the customer, through purchasing the gift card, is promised goods/services at some point in the future. The gift card should only be recorded as revenue when the customer redeems the gift card. If there is any “breakage”, or leftover amount on the gift card that was not redeemed, this amount should be written off of the liability at the end of the year.